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Consequences of Contingent Right Under Section 957

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A [REDACTED] percent U.S. shareholder of a foreign corporation has a contingent right to acquire stock of the foreign corporation held by the foreign corporation's other [REDACTED] percent foreign shareholder. We have been asked whether this right is an option or adds value to the U.S. shareholder's stock, so as to characterize the foreign corporation as a controlled foreign corporation within the meaning of section 957 of the Code.

You have presented the facts as follows. [REDACTED], a domestic corporation, owns [REDACTED] percent of the stock of [REDACTED], which in turn owns [REDACTED] percent of the stock of [REDACTED], a Spanish corporation. The remaining [REDACTED] percent of the stock of [REDACTED] is owned by a Spanish holding company unrelated to [REDACTED]. [REDACTED] is wholly owned or controlled by a Spanish citizen, [REDACTED].

Stated generally, an agreement between [REDACTED] and [REDACTED] (the original of which [REDACTED] could not produce, claiming its failure was the result of turnover in its tax department and relocation of its international offices), provided that the bylaws of [REDACTED] were to be amended to provide that if [REDACTED] interest in [REDACTED] falls below [REDACTED] percent, then [REDACTED] is obligated to offer to [REDACTED] between [REDACTED] and [REDACTED] percent of the shares of [REDACTED]. If this contingency arises, the amount of shares offered to [REDACTED] will be determined by [REDACTED]. The price at which such shares will be offered is described in the agreement.

You have asked whether [REDACTED]'s contingent right to acquire

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the [REDACTED] stock held by [REDACTED] is an option within the meaning of section 318(a)(4) of the Code, or whether the contingent right adds value to the [REDACTED] stock held by [REDACTED]. [REDACTED] seeks to establish that [REDACTED] is a CFC of [REDACTED].

The foreign tax credit limitation described in section 904 of the Code is computed separately for the categories of income described in section 904(d)(1). Section 904(d)(1)(E) provides a separate limitation category for dividends received from each noncontrolled section 902 corporation. A noncontrolled section 902 corporation is defined under section 904(d)(2)(E) as a foreign corporation that is not a controlled foreign corporation within the meaning of section 957, with respect to which the shareholder satisfies the stock ownership requirements of section 902.

Pursuant to section 904(d)(3) of the Code, however, income of a CFC included in the gross income of its U.S. shareholders under section 951(a)(1)(A) is treated as income in the separate limitation categories of section 904(d)(1) to which such income is attributable. Because [REDACTED]'s income from [REDACTED] would be included in the general limitation basket of section 904(d)(1)(I) if [REDACTED] is characterized as a CFC, resulting in a higher foreign tax credit limitation for [REDACTED], [REDACTED] seeks to establish that [REDACTED] is a CFC.

Pursuant to subpart F of the Code, a U.S. shareholder of a CFC is required to include currently in its gross income its share of certain items of income of the CFC. Because there is no dispute in this case that [REDACTED], which owns [REDACTED] percent of the stock of [REDACTED], is a U.S. shareholder of [REDACTED] within the meaning of subpart F, the sole issue is whether [REDACTED] is a CFC. A CFC is defined under section 957(a) as any foreign corporation more than 50 percent of the voting power or value of whose stock is owned by U.S. shareholders. The attribution rules of section 958, which incorporate with certain modifications the rules of section 318, are applied to determine ownership of the stock of the foreign corporation.

Two issues are presented in this case in determining whether [REDACTED] is a CFC of [REDACTED]: first, whether [REDACTED]'s contingent right to acquire [REDACTED] stock from [REDACTED] is an "option" within the meaning of section 318(a)(4) of the Code; and second, whether the contingent right adds value to the stock of the corporation held by [REDACTED]. If the contingent right is an option, then [REDACTED] is treated as owning the shares of stock subject to the option. See sections 958(b) and 318(a)(4). [REDACTED] would be characterized as a CFC of [REDACTED] because [REDACTED] would be treated as owning more than [REDACTED] percent of [REDACTED]'s stock. Similarly, [REDACTED] would be characterized as a CFC of [REDACTED].

██████████ if the contingent right held by ██████████ adds any value to its ██████████ stock, since ██████████ would have more than 50 percent of the value of the stock of ██████████.

Rev. Rul. 68-601, 1968-2 C.B. 124, holds that to qualify as an option, the interest holder must have the right to obtain the stock at his election. If the holder's right is contingent rather than absolute, the right is not an option for purposes of section 318 of the Code. Rev. Rul. 68-601 is clarified by Rev. Rul. 89-64, 1989-1 C.B. 91, which holds that a right that is exercisable only after a period of time has elapsed is an option within the meaning of section 318(a)(4). Under the facts of the revenue ruling, a shareholder of a corporation received cash and a right to acquire 15 shares of stock in the corporation (exercisable only after a fixed period of time had elapsed), in redemption of 15 of his 30 shares of stock. The ruling concluded that the interest must be characterized as an option. Therefore, because the shareholder was treated under section 318(a)(4) as owning the shares of stock subject to such option, the redemption was not a substantially disproportionate redemption of stock within the meaning of section 302(b).

The facts of Rev. Rul. 89-64 may be distinguished from those of this case. The passage of time, quite obviously, is not a contingency. Moreover, there does not appear to be any risk that the interest holder will be unable to acquire the stock that is the subject of the option. In this case, however, ██████████ may not exercise its right of first refusal unless the shareholders of ██████████ decide to dispose of their interest in ██████████. This is clearly a contingency. In addition, ██████████ is free to dispose of its interest in ██████████ prior to the occurrence of the contingency described in ██████████'s contract with ██████████, without first offering any shares to ██████████. Thus, even if the contingency occurs, there is no guarantee that shares will be available for purchase by ██████████ if it were to exercise its right of first refusal. On this basis, we may conclude that the interest at issue in this case is not an option within the meaning of section 318(a)(4) of the Code. See LTR 8038048 (attached) (for purposes of sections 1249 and 958, a right of first refusal is not an option because the interest holder is not able to exercise such right at its election).

Moreover, there is no support for the argument that the interest held by ██████████ adds value to its shares for purposes of section 957(a) of the Code. Section 1222(a)(1) of the Tax Reform Act of 1986 amended section 957(a) to provide that CFC status would be determined with reference to vote and value. Under

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prior law, only voting power was considered.¹ Congress was concerned about avoidance of the provisions of subpart F by shareholders holding 50 percent or less of the voting power of a foreign corporation but greater than 50 percent of its value in the form of shares of nonvoting stock. See S. Rep. No. 99-313, 99th Cong., 2d Sess. 371 (1986). The contingent interest in the stock of ██████████ does have value, but its value is independent of that of the stock held by ██████████ or ██████████ and should impart no value directly to such stock. Therefore, it is appropriate not to impute any value to ██████████'s interest in ██████████ that is attributable to the value of ██████████'s contingent right.

For the foregoing reasons, ██████████ holds only 50 percent of the voting power and value of ██████████. Therefore, ██████████ is a noncontrolled section 902 corporation of ██████████ within the meaning of section 904(d) of the Code.

If you have any further questions or comments, please call me or Jim Sams at FTS 566-6645.

Phyllis E. Marcus

Attachment

¹ Note that in LTR 8038048, we refused to rule on the effect of the right of first refusal on the voting power of the interest holder, determining that the issue was too factual.